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TAGS: EFIN EPET ECON IN
SUBJECT: STATE-OWNED OIL MARKETING COMPANIES LEFT WITH FEW CHOICES AS PETRO-PRODUCT RETAILING IN INDIA BECOMES INCREASINGLY UNSUSTAINABLE

REF: 07 MUMBAI 0672

MUMBAI 00000244 001.2 OF 005

Summary:

¶1. (U) The three state-owned integrated oil refining and marketing companies (OMCs) have been hit by a triple whammy -- spiraling crude oil prices of over USD 120 a barrel, the depreciating rupee via-a-vis the dollar, and a higher inflation rate of over 7 percent. These three factors have widened the discrepancy between the actual cost of petro-products and the "politically acceptable" sale price that is determined by the Indian government. The OMCs will have to absorb USD 3.8 billion in losses in 2007-08, even after the government and state-owned upstream oil companies partially compensate them for their losses through the issue of oil bonds and subsidies. The OMCs still have to gain the experience to participate in the relatively nascent commodities market to hedge against future crude price increases. The federal government is considering several options to ease the woes of the state-owned OMCs after international oil prices crossed USD 130 a barrel last week, but it has yet to announce a price increase for the "controlled" petro-products. The OMCs, left with little choice, have proposed curtailing their losses through "rationing" measures.

¶2. (U) Due to India's shortage of petro-products, especially diesel, the Government of India prevents the state-owned OMCs from exporting and, consequently obtaining free market prices, for their refined petro-products in the international market. The refinery expansions of Reliance Industries and Essar Oil will add significant refining capacity in India, and if Reliance's claims are to be believed, may even help ease the international crude oil rise which is partially linked to a world-wide refining capacity shortage. Both companies said that

they will be able to meet domestic demand as well as export refined petro-products once the refinery expansions are completed. End Summary.

Mounting Losses Force OMCs to "Ration" Supplies

¶3. (U) State-owned integrated refining and marketing companies -- Indian Oil Corporation, Bharat Petroleum Corporation and Hindustan Petroleum Corporation - claim that they lose over USD 100 million each day by selling petrol, diesel, kerosene and domestic cooking gas below the actual production price. According to a report prepared by Enam Securities, a leading Mumbai-based brokerage, the Indian consumer pays around USD 49 per barrel for these products although the Indian oil basket averaged USD 110 a barrel in April. The Indian government believes that increasing the domestic prices of these products in line with the rise in international oil prices will result in a cascading effect on the entire economy and will bring immense hardship to the "aam aadmi" (common man). The Ministry of Petroleum & Natural Gas has estimated the gross under-recoveries -- the shortfall between cost of production and the selling price -- of the OMCs at around USD 18 billion in 2007-08. ABN-Amro estimates these under-recoveries will more than double to USD 46 billion during 2008-09 if international crude oil prices remain over USD 120 per barrel.

¶4. (U) The Enam report maintains that the retail prices of petrol and diesel need to be raised by 44 percent and 66 percent, respectively, and the prices of domestic cooking gas and kerosene supplied through the public distribution system have to rise by 68 percent and 300 percent, respectively, to pass on the full impact of the international oil price rise. Vinod Panjwani, Senior Manager (International Trade) for Bharat Petroleum Corporation (BPCL) explained that oil companies suffer the maximum loss on account of low diesel prices due to the

large volume of diesel consumed in the country. Diesel accounts for 37 percent of petro-consumption; the Enam report estimates that under-recoveries would drop by USD 1.4 billion if diesel prices were increased by one rupee. However, Panjwani noted that diesel is a mass-consumption fuel used for the transportation of goods and agricultural pumps and tractors and is more price sensitive than petrol, which is used primarily in private automobiles. The government, therefore, prices diesel lower than petrol to avoid a diesel price-driven compounding impact on inflation, although both petrol and diesel cost almost the same to produce, he explained.

¶5. (SBU) Media reports state that the Finance Ministry has agreed to issue oil bonds worth USD 8.4 billion in 2007-08 to compensate OMCs for around 46 percent of their gross under-recoveries. Of this, oil bonds worth USD 4.8 billion have already been issued to the OMCs in April-December 2007 according to the Ministry of Petroleum & Natural Gas. An economist at Enam Securities told Congenoffs that the maturity of oil bonds is primarily 10-15 years. The bonds are given to the OMCs, who then sell them to state-owned insurance companies and pension funds, which are the only bodies allowed legally to buy them. These institutions then often re-sell them to banks at a discount. Since they do not qualify under the Statutory Liquidity Requirement (SLR), which requires banks to hold a certain amount of their capital in government securities, banks are reluctant to buy them unless at a discount, he explained. According to the Enam economist, these bonds are distributed to the OMCs in tranches in a non-transparent, ad-hoc fashion. OMCs do not know when to expect the next tranche of bonds and, therefore, cannot gauge their future liquidity or cash flows, he maintained.

¶6. (SBU) Despite the non-transparent and uncertain nature of the bonds, the OMCs have repeatedly petitioned the Finance Ministry to increase the government's share to 57 percent of the total under-recoveries by issuing additional oil bonds. (Note: Under the current burden-sharing arrangement, the government

issues oil bonds to sustain 42.7 percent of the under-recoveries, oil prospecting or upstream companies bear 33 percent of the total loss through price discounts, and the balance is borne by the state-owned OMCs. End Note) The OMCs will therefore have to absorb the balance of USD 3.8 billion in under-recoveries in 2007-08, after the issue of the remaining bonds and subsidies by the upstream oil companies. However, tax revenue and import duties from crude oil and domestic petrol and diesel sales is significant, and some analysts believe this income is as large or larger than the losses that the OMCs incur for selling their products at below cost. In 2006-07, the government collected around USD 17 billion of excise and customs duties from crude oil and petroleum products. V. Ramamurthy, Head-Technical of Essar Oil, told Congenoffs that the growth of the service sector has resulted in a substantial increase in its contribution to tax revenue and, consequently, the percentage of tax revenue contribution by the oil sector has therefore gone down in relative terms. The government is therefore no longer dependent on the tax revenue from the oil sector to finance its expenditure, he continued. The Finance Ministry may be reluctant to reduce the revenue stream for fear of allowing India's high fiscal deficit to inflate even more, however.

¶7. (SBU) BPCL's Panjwani admitted that the cap on the retail prices of petroleum products wiped out all profits his company made by its refining operations. He also noted that India's energy crunch created a significant supply-side bottleneck which,if corrected, would substantially increase India's growth rate. Nevertheless, Panjwani pointed out that the "socialist" nature of the government, the upcoming state assembly elections, and possibility of early national elections prevented the

government from raising retail prices of petroleum products to "politically unbearable" levels. Media reports state that BPCL plans to limit the amount of petrol and diesel supplied to its retail outlets to the amount sold by the outlets during the same period last year. Reports claim that BPCL and the other state-owned OMCs also plan to "freeze" new cooking gas connections, fix a quota of one cooking gas cylinder per family, curtail the import of diesel and hold off on expanding the retail outlet network in the country to ride out the current oil price rise and to reduce their mounting under-recoveries. (Note: The Ministry of Petroleum & Natural Gas has publicly stated that it is committed to ensuring uninterrupted supplies of petrol and diesel and denounced any move to restrict or ration supplies. However, state-owned OMCs claim that they are forced to "restrict" sales of petro-products due to limited availability. End Note). State-owned OMCs are also thinking of promoting only branded, costlier petrol and diesel, which are priced at a premium over the government-determined retail prices, hoping that customers will be willing to pay more for branded fuels which give greater mileage, lower emission and maintenance costs and cleaner engines.

Private Refiners Opt out of Marketing Business but Still Hang on to Assets

¶8. (SBU) Private-sector oil marketing companies do not receive oil bonds and cash discounts to compensate for the shortfall between the government-determined selling price and actual production cost, unlike state-owned OMCs. Private-sector OMCs are theoretically not "bound" by the retail caps on petrol and diesel. However, they have no choice but to sell their products at the "controlled" government prices or risk losing market share. Both of the privately-owned OMCs -- Essar Oil and Reliance Industries -- have abandoned their oil retail expansion plans citing the absence of a "level-playing field" between private and state-owned OMCs. However, Reliance Industries and Essar Oil have not yet exited the oil marketing business, as both believe that the situation could change in the future. Either the government would be forced to allow the price to rise or crude oil prices could fall, they opined. Although Reliance Industries has closed its 1,400 oil retail outlets, it is still holding on to the retail assets. Essar Oil's Sudip Rungta

explained that Essar took a strategic decision to price petrol and diesel sold at their outlets at a much higher price than that sold at state-owned retail gas stations. Consumers are, therefore, unlikely to buy from their outlets and would prefer to use the state-owned retail stations. Essar Oil operates these 1,500 retail outlets through franchisees but Rungta claimed that the company compensates its franchisees to maintain its retail operations.

Host to Asia's Largest Grassroots Refinery, India Faces Refining Capacity Shortage
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¶9. (U) Provisional data from the Director General of Commercial Intelligence & Statistics under the Ministry of Commerce shows that India's consumption of petroleum products in 2006-07 was 120 million tons. Total production of petroleum products during the same period stood at 135 million tones, indicating a supply surplus of 15 million tons. However, 32 million tones of petrol, oil and lubricants were exported, leaving the country short of 17 million tons of these products which had to be imported.

¶10. (SBU) The three-state owned OMCs supply exclusively to the domestic market. Since India faces a shortage of refined petrol and diesel, privately-owned Essar Oil also currently supplies

all refined petroleum products manufactured at its 10.5 million ton refinery to the domestic state-owned refiners. The company sells these products at the refinery-gate price or the import-parity price which is equivalent to the landed cost of imported petroleum products and includes customs and excise duties, freight, and transportation costs. Essar's Ramamurthy explained that "hospitality" and "product-sharing arrangements" between all oil refining-marketing companies assured that state-owned OMCs would always buy Essar Oil's products at international-equivalent prices. Reliance Industries -- the owner of Asia's largest greenfield refinery -- exports almost all of the petroleum products (excepting LPG) processed at its 33 million ton refinery at Jamnagar in Gujarat. BPCL's Panjwani argued that Reliance should be banned from exporting its product and should be "forced" to supply to the domestic market as India had a deficit in meeting its petroleum consumption needs. In a separate discussion, Hital Meswani, Executive Director of Reliance Industries, claimed that state-owned refining companies cannot export their petro-products as they are not able to meet international specifications.

¶11. (U) Reliance is currently building another refinery at Jamnagar which would make it the largest refining complex in the world, with a refining capacity of around 66 million tons or nearly 1.2 million barrels of oil per day. The new refinery is expected to be completed by December 2008. Meswani said that Reliance will be able to meet domestic demand and continue exporting with the new capacity. According to Meswani, the new refinery will be able to process all types of crude oil (heaviest to lightest) from anywhere in the world and can export the refined product to any country based on their particular specification, he maintained. The refinery will help ease the world-wide refining capacity shortage, which Meswani claims is linked to the current international oil price rise.

¶12. (U) Essar Oil is also planning to expand its existing 10.5 million ton refinery to 34 million tones in two stages at a total cost of USD 6 billion. In the first stage, the refining capacity would increase to 16 million tons through debottlenecking to remove the limits on output capacity.. New expansion would subsequently increase refining capacity by another 18 million tons. While the company can claim tax benefits for the first expansion phase, it would not be able to commence its 18-million ton expansion plan before March 31, 2009 which is the last date for claiming the tax benefits for existing and new refineries. For this reason, Ramamurthy explained, the company is considering setting up the new refinery in a special economic zone so that it can avail of

export tax benefits. The completion of the 34-million ton refinery will enable Essar Oil to export around 50-60 percent of refined petroleum products and to supply the rest to the domestic market, Ramamurthy added.

Oil Futures Trading: the Answer or a Distant Dream?

¶13. (U) The National Commodities Derivatives Exchange (NCDEX) and the Multi-Commodity Exchange (MCX) offer the trading of crude oil and furnace oil futures contracts in India. Indian OMCs are not allowed to trade in foreign oil futures contracts. The crude oil futures contracts offered by the two commodity exchanges mimic the oil futures contracts on the New York Mercantile Exchange (NYMEX) and the Intercontinental Exchange (ICE), because, as Arvind Pal Singh, Assistant VP (Energy) of NCDEX, pointed out, India has only 2-3 percent of the world's crude oil reserves. Crude oil futures contracts are used for risk-mitigation rather than price discovery in India, he continued. NCDEX has only one indigenous contract linked to the domestic price of crude oil. In contrast, furnace oil

futures contracts are designed for price-discovery. There are no futures contracts for refined products like petrol and diesel because prices are "controlled" by the government. There is zero price risk and no scope for price discovery for these products, he added.

¶14. (U) Refiners can hedge against their crude oil import exposure based on their past performance, or up to 50 percent of their one-year or three-year inventories. Nevertheless, the oil futures market in India suffers from low penetration and inadequate liquidity, Pal Singh admitted. There are only a handful of end-consumers for crude and furnace oil like refiners and proprietary power generating companies who face a price risk and therefore have an incentive to participate, he continued. Participation is low even among these limited beneficiaries, he continued. BPCL's Panjwani also confirmed that the participation of oil companies in the futures trading market on both the NCDEX and MCX is negligible. Pal Singh pointed out that the commodity markets are relatively new in India and online trading in commodity futures started only in 2003. The markets still have to gain depth and liquidity and participants have yet to become savvy at hedging, he continued. Moreover, refining companies and proprietary power generating companies prefer forward trading through the Over-the-Counter market, rather than engage in futures trading, he added.

Comment:

¶15. (SBU) The structure of the oil bonds issued to partially mitigate the losses of the state-owned OMCs lack transparency and are shrouded in secrecy. One commodity trader and Indian Oil Corporation shareholder told Congenoffs that the CFO of the Indian Oil Corporation has declined to provide information on the coupon rate and maturity of the oil bonds; Enam Securities confirmed the opaque nature of these bonds. State-owned entities (public-sector banks and pension funds) are the only buyers of these bonds, which raises questions about their overall liquidity. In fact, the Chairman of Oil & Natural Gas Corporation (ONGC), a state-owned upstream company, told press recently that he has refused to accept oil bonds as payment for crude oil sales to the OMCs, but has instead offered to lend these companies part of its cash surplus to help ease their liquidity crunch. It is, therefore, perplexing that the state-owned OMCs look to the bonds as their only means of survival and have repeatedly asked the Finance Ministry to increase the amount of oil bonds allotted to them. The government's pro-consumer policy of preventing market-driven pricing of retail prices of petro-products and thereby creating market distortions is fiscally unviable. The three oil marketing companies in India are all state-owned and must remain in the business even when losses mount. Consumers and oil companies will continue to watch with wary eyes as and when a

policy change is announced. Central government policy approaches to this dilemma will be reported in a New Delhi septel. End Comment.
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